
FRBSF WEEKLY LETTER

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Selling Government Assets

In the market for a dam? How about Grand Coulee dam — the world's second largest concrete dam? Prefer an airport? Would you be interested in Dulles International Airport outside Washington, D.C.? Too far out of town? Well, Washington's National Airport is also available. For more information, contact the Reagan Administration.

The Bonneville Power Administration, which operates Grand Coulee dam, and Dulles and National Airports are just some of the federal government assets listed for sale in the 1987 fiscal year budget that President Reagan recently sent to Congress. National Weather Service satellites, Naval Petroleum Reserves, Small Business Administration loans and some housing loans are also on the list.

"Privatization" is the term recently coined to describe the transfer of federal government assets and agencies to the private sector. Whether a particular activity should be carried out by the private sector or the public sector depends on the relative efficiency of the two sectors and the presence or absence of market failures — situations in which market forces are not well suited to producing efficient allocations of goods and services. Supporters of privatization believe that the federal government currently engages in a wide variety of activities for which the private sector is better suited.

This *Letter* focuses not on the general merits or demerits of "privatization", but on the narrower issue of whether selling government assets can contribute to reducing the deficit problem, as some proponents claim. Reported federal deficits would be reduced by asset sales, but the disposal of those assets will in no way ameliorate the deleterious effects of government expenditures that exceed tax revenues. Examining why this is the case also helps illustrate how unreliable the reported deficit is as an indicator of the impact of the federal budget on the economy.

Federal budget deficits

It is easy to see why the federal government is searching for innovative ways to reduce its budget deficit. Historically high recent budget deficits have led to a huge increase in the outstanding stock of government debt. At the end of fiscal year 1980, the total outstanding debt of the federal government held by the public (excluding, that is, holdings by the Federal Reserve System) was just under \$600 billion. By the end of fiscal year 1986, that figure had doubled. Moreover, the Congressional Budget Office's most recent projection shows that large increases in the accumulated government debt most likely will continue for the rest of the decade. The fiscal year deficit is projected to drop in future years from the \$208 billion level it reached in 1986, but projections show it will still exceed \$100 billion in 1990.

Federal budget deficits can be reduced either by cutting spending or by increasing revenue. Given the political difficulties of the former, and the President's opposition to tax increases, the sale of government assets seems to provide a happy solution. These assets constitute an enormous source of wealth, and their liquidation could generate large amounts of revenue.

The value of federal assets

Some recent attempts have been made to estimate the value of the assets held by the federal government. The federal government owns both tangible (structures, equipment, inventories and land) and financial (gold, currency, deposits, mortgages and other loans) assets. As of the end of 1980, the Bureau of Economic Analysis of the Department of Commerce estimated that the replacement value of government structures, equipment and inventories totaled \$608 billion.

The value of land owned by the federal government in 1981 was \$175 billion, not including the total value of oil and gas mineral rights on that same land. Recent work by Michael Boskin,

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Marc Robinson, Terrence O'Reilly, and Praveen Kumar pegged the value of these mineral rights at about \$820 billion 1981. Since the estimated value of federal land may include some of the capitalized value of these mineral rights, adding the value of land to the value of the mineral rights would involve some double counting. Nevertheless, these estimates suggest that the total value of the government's tangible assets is in the neighborhood of \$1.5 trillion.

The financial assets of the federal government totaled \$707 billion at the end of 1980. This included \$152 billion in gold, \$126 billion in mortgages and \$200 billion in other loans.

Added together, these estimates of tangible and financial asset holdings yield a value of over \$2 trillion. By comparison, the total real market value of the federal government's debt at the end of 1980 was \$1.15 trillion. By selling its assets, the federal government could more than retire its debt. But would this be good for the economy? Not necessarily. Focusing only on the debt of the federal government — the liabilities side of the balance sheet — can give a misleading impression of the government's financial health.

Crowding out

To understand the effect a sale of government assets will have on the problems caused by federal budget deficits, a distinction must be made between the effect of such a sale on the economic problems normally attributed to deficits and the effect such a sale has on the *reported* budget deficit.

When the government borrows, it adds to the total demand for credit in the economy. Normally, an increase in the demand for credit, whether it originates from the government or from households or corporations, would tend to lead to increased interest rates. The rise in interest rates works to keep credit markets in equilibrium in two ways. First, by making saving more attractive, it increases the total supply of credit. Second, by raising the cost of borrowing, it reduces the demand for credit.

Since the government tends to borrow what it needs regardless of the level of interest rates, it is the private sector whose borrowing is reduced by a rise in interest rates. Government bor-

rowing, by raising interest rates, therefore crowds out some private borrowing. As a result, households and firms reduce their investment in tangible productive assets.

It is possible, however, for deficits not to crowd out private borrowing. If savings rose, they may generate enough new credit to supply the government's borrowing needs without a rise in interest rates or a fall in investments. Savings may rise if households recognize that current deficits imply higher future taxes. That is, if the trend in government expenditures remains unchanged, a cut in taxes implies that, some time in the future, there must also be a rise in taxes. Households might increase their current saving to pay for the higher expected future taxes.

But except for the special case in which private saving increases enough to meet the government's borrowing needs, federal deficits *do* impose a real cost on the economy by affecting the aggregate demand for credit. The major cost of government deficits over the long-run arises from the effect of higher real interest rates and lower private investment on the economy's capital stock. Because financing government deficits reduces private investment, the economy will have a smaller private stock of capital in the future. This, in turn, means that the economy's productive capacity will be smaller and incomes in the future will be lower. The real cost of government deficits therefore is lower real income in the future.

When government borrowing tends to raise domestic interest rates, investment funds will be attracted from abroad. Since this capital inflow represents an increase in the supply of credit available to finance government borrowing, there will be less crowding out of domestic investment than would occur in a closed economy.

At first glance, foreign capital inflows mean that there will be a higher capital stock in the future, and thus higher levels of real production. Foreign investors, however, own claims on this higher income. Because foreign lenders must be paid back, the domestic economy receives lower income in the future as a result of past government borrowing.

Offsetting effects

The effects of a sale of government assets on the economic problems due to the federal government's deficits will depend on how such a sale affects the economy's total demand for credit.

The proceeds from the sale of an asset would directly reduce the amount of borrowing the federal government would need to undertake, and thereby reduce the aggregate demand for credit. For every sale, however, there must be a buyer. And the buyer of the asset must raise the purchase price by borrowing. The buyer therefore increases the demand for credit by an amount exactly equal to the fall in the government's demand, offsetting its effect on the total demand for credit.

Selling the assets of the federal government is likely then to have *no* net effect on the total demand for credit in the economy. Such a sale cannot, in any way, reduce the detrimental effects of government borrowing. However, because the federal government operates on a cash budget basis, the entire proceeds from the sale of an asset would be reported as income at the time of the sale, thereby reducing the *reported* deficit. If, as do corporations, the federal government kept separate capital and current budgets, it would be clear that the sale of an asset owned by the government has no effect on the balance between its current expenditures and revenues. The reported federal deficit therefore can be a very poor guide to the true effect of government expenditures and taxes on the economy.

Some opponents of the sale of federal government assets have argued that liquidation sales are undesirable because they would actually make future deficits worse if assets that generate revenue for the government are sold. An example of a revenue-generating asset is the Grand Coulee dam, which produces hydroelectric power. But this reasoning fails to consider that the price at which a government asset can be sold will equal the current value of the future income a private operator could earn from owning that asset. In other words, the value of the Grand Coulee dam's future revenues would be reflected in its sale price.

Moreover, if the private sector is able to operate more efficiently than the government, the price it would be willing to pay for, say, the Grand

Coulee dam, would exceed the value of the dam's future revenues under continued government operation. Conversely, if the government is the more efficient operator, the price a private investor would be willing to pay would fall short of the value of future income the government could earn by maintaining operation. Simply changing the ownership of an existing economic asset therefore has no effect unless the new owner's efficiency in operating the asset differs from that of the original owner.

Borrowing differently

While the federal government may reduce its current reported deficit by selling an asset, it will have set the stage for a rise in future reported deficits by foregoing the future revenues produced by the asset. In essence, the government will have converted future revenue into current revenue. This is just like borrowing directly, whereby the government converts future tax revenues into current revenue by issuing debt that must be paid off in the future.

An imbalance between spending and income, and its economic effects, cannot be corrected by liquidating some of the federal government's assets. Receipts from such sales are not income since they simply represent the exchange of one asset, such as an airport, for another asset, such as money. If the receipts are used to finance current expenditures, the government has reduced its wealth — it has "dis-saved" — by exactly the same amount as it would if it had borrowed directly to finance its expenditures. In both cases, the dis-saving of the government must be financed by the saving of other sectors of the economy. And this leaves less saving available to finance private investment.

This *Letter* has only examined the impact of asset sales on the economic effects of the deficit. The more fundamental issue of whether deficits are too large or too small depends on how the government uses the funds it borrows, whether public capital (schools, dams, roads) is more productive than alternative private investment projects, and the relative efficiency of public versus private provision of services. Reported deficits therefore cannot always accurately measure the impact of government on the private economy.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT (Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/23/86	Change from 4/16/86	Change from Dollar 4/24/85	Percent ⁷
Loans, Leases and Investments ^{1 2}	201,840	- 1,915	11,958	6.2
Loans and Leases ^{1 6}	183,588	- 1,879	11,714	6.8
Commercial and Industrial	52,666	- 837	393	0.7
Real estate	66,487	- 136	3,641	5.7
Loans to Individuals	39,045	- 23	5,234	15.4
Leases	5,648	3	297	5.5
U.S. Treasury and Agency Securities ²	10,389	- 15	- 659	- 5.9
Other Securities ²	7,862	- 23	901	12.9
Total Deposits	201,830	- 4,150	8,334	4.3
Demand Deposits	49,106	- 3,579	4,989	11.3
Demand Deposits Adjusted ³	33,987	- 411	4,529	15.3
Other Transaction Balances ⁴	16,213	- 720	2,615	19.2
Total Non-Transaction Balances ⁶	136,510	147	729	0.5
Money Market Deposit Accounts—Total	46,187	- 95	2,877	6.6
Time Deposits in Amounts of \$100,000 or more	36,652	287	- 2,046	- 5.2
Other Liabilities for Borrowed Money ⁵	27,922	1,563	5,768	26.0
Two Week Averages of Daily Figures	Period ended 4/21/86	Period ended 4/7/86		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (-)	96	- 3		
Borrowings	43	17		
Net free reserves (+)/Net borrowed(-)	53	- 20		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately

⁷ Annualized percent change